IT 07-6
Tax Type: Income Tax
Issue: Allowable Deductions
Reasonable Cause on Application of Penalties

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

JOHN DOE & JANE DOE,	)	Docket No. 00-IT-0000
Taxpayers	)	Tax ID Nos. 000-00-0000, 000-00-0000
v.	)	Tax Years 1999, 2002
THE DEPARTMENT OF REVENUE	)	John E. White,
OF THE STATE OF ILLINOIS	)	Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Timothy Hughes, Lavelle Law, Ltd., appeared for John Doe & Jane Doe; Ralph Bassett, Special Assistant Attorney General, appeared for the Illinois Department of Revenue.

Synopsis:

This matter arose after John Doe and Jane Doe (taxpayers) protested the Department of Revenue's (Department's) partial denials of amended Illinois income tax returns taxpayers filed regarding calendar years 1999 and 2002 to request refunds of amounts paid regarding those years. In a pre-hearing order, the parties stipulated to certain revisions to the Department's partial denials. The same order presented three remaining issues: whether taxpayers are entitled to a credit for tax paid to the state of Oklahoma for 1999; whether taxpayers should be allowed personal exemptions for their two children for 1999 and 2002; and whether reasonable cause exists to abate penalties the Department assessed regarding 1999 and 2002.

The hearing was held at the Department's offices on Chicago, Illinois. John Doe testified at hearing, and taxpayers also offered documentary evidence. After considering the evidence admitted at hearing, I am including in this recommendation findings of fact

and conclusions of law. I recommend the issues be resolved in favor of the Department, and that the partial denials be finalized as revised by the parties' stipulations.

Findings of Fact:

1. Taxpayers, John Doe (John Doe) and Jane Doe (Jane Doe), are husband and wife, and reside in Illinois. *See* Department Exs. 2, 4 (copies of, respectively, taxpayers' Illinois amended returns for 1999 and 2002); Hearing Transcript (Tr.) p. 29 (John Doe).
2. John Doe is a thoracic surgeon; Jane Doe had previously been a professor of tax law. Tr. pp. 29-30 (John Doe).
3. Taxpayers filed amended joint Illinois income tax returns regarding calendar years 1999 and 2002. Department Exs. 2, 4.
4. Taxpayers filed the amended Illinois returns to seek a refund of tax and penalties the Department assessed, and taxpayers paid, regarding calendar years 1999 and 2002. Department Exs. 2 (p. 2, Step 3, line 32), 4 (p. 2, Step 3, line 34).
5. Taxpayers filed the amended Illinois returns following their receipt of two letters and/or notices the Department issued to them on, respectively, 6/30/03 and 2/23/05. Department Exs. 2, 4 (p. 2, Step 3, of each return); Taxpayer Ex. 2 (copy of page 2 of form ITR-76 dated 6/30/03, regarding taxpayers' form IL-1040 for 1999); Taxpayer Ex. 7 (copy of taxpayers' protest, dated 2/7/06, with attachments), p. 5 (copy of Department form EDC-87-A, Final Notice of Intent to Levy Assets, dated 2/23/05); *see also* Taxpayer Ex. 11 (copy of page 2 of form ITR-76 dated 2/23/05, regarding taxpayers' form IL-1040 for 2002, identifying basis for penalty).
6. In different letters and notices, the Department notified taxpayers that they had been assessed the following penalties, for the following years:

1999		2002	
underpayment of estimated taxes	$375.96	late payment	$1,871.85
late filing	$194.04		
late payment	$194.04		

Taxpayer Exs. 2, 7 (p. 5), 11.

7. Jane Doe had prepared taxpayers' federal and state tax returns since they were married, in 1980, through 2002. Tr. pp. 30-31 (John Doe).

8. Since 2005, Jane Doe has been unable to work due to physical ailments, including multiple sclerosis. Tr. pp. 30-32, 36-39 (John Doe).

9. In 1999, taxpayers' adjusted gross income (AGI) was $344,474; in 2002, it was $440,644. Department Exs. 2, 4 (p. 1, Step 2, line 1, of each return).

10. On the amended Illinois returns filed for 1999 and 2002, taxpayers reported four personal exemptions, one for each of them, plus one for each of their two children. Department Exs. 2, 4 (p. 1, Step 2, line 12, of each return).

11. On their amended Illinois return for 1999, taxpayers reported a credit from Schedule CR, in the amount of $1,016, for tax paid to the state of Oklahoma. Department Ex. 2 (p. 1, Step 2, line 19); Pre-Hearing Order, ¶ 2.1.2; Taxpayer Ex. 10a (copy of completed, signed Oklahoma individual non-resident return for 2002.

12. Just prior to hearing, taxpayers caused to have prepared a form 511NR, which is an Oklahoma non-resident income tax return, regarding 1999. Taxpayer Ex. 10a, pp. 1-2 (copy of completed 1999 Oklahoma form 511NR). Taxpayers signed that Oklahoma return, which was dated 4/25/07. *Id.*, p. 2. That signed Oklahoma return showed a total tax due of $1,939, of which $1,761 had previously been withheld from wages paid to Jane Doe. *Id.*; Taxpayer Ex. 8 (copies of W-2 forms issued to taxpayers for 1999).

13. John Doe also signed, contemporaneously with the Oklahoma tax return, a personal check made payable to the Oklahoma Tax Commission in the amount of $178 (1,939 – 1,761 = 178). Taxpayer Ex. 10a, p. 3 (copy of check no. 6791, dated 4/25/07).

Conclusions of Law:

When a taxpayer seeks to take advantage of deductions or credits allowed by statute, the burden of proof is on the taxpayer. Balla v. Department of Revenue, 96 Ill. App. 3d 293, 296, 421 N.E.2d 236, 238 (1st Dist. 1981). Here, taxpayers claim a refund of tax and penalties paid to the Department; therefore, they have the burden of proof.

Issue I: Credit for Tax Paid to Oklahoma for 1999

Section 601(b) of the Illinois Income Tax Act (IITA) (and unless otherwise indicated, all statutory citations in this recommendation will refer to the IITA) provides credits that may be applied against the amount of tax the person owes for a given year. 35 **ILCS** 5/601(b). Section 601(b)(3) provides a credit for certain amounts of foreign tax that may have been imposed upon a resident taxpayer's income. Specifically, that subsection provides:

> (3) Foreign tax. The aggregate amount of tax which is imposed upon or measured by income and which is paid by a resident for a taxable year to another state or states on income which is also subject to the tax imposed by subsections 201(a) and (b) of this Act shall be credited against the tax imposed by subsections 201(a) and (b) otherwise due under this Act for such taxable year. The aggregate credit provided under this paragraph shall not exceed that amount which bears the same ratio to the tax imposed by subsections 201(a) and (b) otherwise due under this Act as the amount of the taxpayer's base income subject to tax both by such other state or states and by this State bears to his total base income subject to tax by this State for the taxable year. The credit provided by this paragraph shall not be allowed if any creditable tax was deducted in determining base income for the taxable year.

> Any person claiming such credit shall attach a statement in support thereof and shall notify the Director of any refund or reductions in the amount of tax claimed as a credit hereunder all in such manner and at such time as the Department shall by regulations prescribe.

35 **ILCS** 5/601(b)(3).

In 2002, the Department adopted a new Illinois Income Tax Regulation (IITR), "to provide[ ] guidance for Illinois residents who are subject to tax in another state and are therefore entitled to a credit under IITA Section 601(b)(3)." 26 Ill. Reg. 13237, 13328 (Notice of Adopted Amendments) (vol. 26, iss. 36) (Sept. 6, 2002) (a pdf copy of this issue of the Illinois Register is available to view on the Illinois Secretary of State's website, at http://ilsos.net/departments/index/register/register_volume26_issue36.pdf) (last viewed on August 29, 2007); 86 Ill. Admin. Code § 100.2197. That regulation provides, in pertinent part:

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> g) Documentation required to support claims for credit. Any person claiming the credit under IITA Section 601(b)(3) *shall attach a statement in support thereof and shall notify the Director of any refund or reductions in the amount of tax claimed as a credit under IITA Section 601(b)(3) all in such manner and at such time as the Department shall by regulations prescribe.* No credit shall be allowed under this Section for any tax paid to another state nor shall any item of income be included in base income subject to tax in that state except to the extent the amount of such tax and income is evidenced by the following documentation attached to the taxpayer's return (or, in the case of an electronically-filed return, to the taxpayer's Form IL-8453, Illinois Individual Income Tax Electronic Filing Declaration), amended return or claim for refund:
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> 1) Unless otherwise provided in this subsection (g), a taxpayer claiming the credit must attach a copy of the tax return filed for taxes paid to the other state or states to the taxpayer's Illinois income tax return, Form IL-8453, amended return or claim for refund.

> 2) If the tax owed to the other state is satisfied by withholding of the tax from payments due to the taxpayer without the necessity of a return filing by the taxpayer, the taxpayer must attach a copy of the statement provided by the payor evidencing the amount of tax withheld and the amount of income subject to withholding.
> 3) A taxpayer claiming a credit for taxes paid by a Subchapter S corporation or partnership on the taxpayer's behalf must attach a copy of the statement provided to the taxpayer by the Subchapter S corporation or partnership pursuant to subsection (f) of this Section, showing the taxpayer's share of the taxes paid and the income of the taxpayer on which the taxes were paid.

86 Ill. Admin. Code § 100.2197(g).

Here, taxpayers offered into evidence a copy of a signed Oklahoma tax return for 1999, as well as a check drawn payable to the Oklahoma Tax Commission in the amount of the tax shown due on that return. Taxpayer Ex. 10a. They also introduced a copy of a W-2 form showing tax withheld from Jane Doe's wages during 1999 by her employer, the University of Tulsa. Taxpayer Ex. 8. Those documents were admitted without objection. Tr. p. 26.

The Department contends that taxpayers have not satisfied their burden of showing that they are entitled to the credit for the tax paid to Oklahoma because they offered no evidence to show that the return admitted into evidence was, in fact, filed with the state of Oklahoma. Department's Brief, p. 3. The Department points out that taxpayers offered no documentary evidence of filing, nor did John Doe testify that he mailed the original return and check drawn to pay the amount shown due. *Id*. The Department is correct, and the point is not immaterial — it is critical. When Taxpayer Ex. 10a was offered into evidence, it was identified as "the 1999 State of Oklahoma

Income Tax Return that has been filed with revenue for the State of Oklahoma showing a deficiency due of $178, which the taxpayers have paid." Tr. p. 21. But the person who identified it as such was taxpayers' counsel, who was not a witness. *Id*. John Doe never testified that the Oklahoma return was, in fact, placed into an envelope that was addressed to the Oklahoma Tax Commission and then placed into a mailbox, and thus, filed. He was never asked any questions about that return, at all. In short, there is absolutely no competent evidence in this record that taxpayers filed a return with Oklahoma for 1999.

In their reply brief, taxpayers argue that since their Oklahoma return for 1999 showed a deficiency — that is, it showed that they owed more than the amount withheld — that deficiency proves that the monies withheld were, in fact, paid to the state of Oklahoma. Taxpayers' Reply, p. 1. It does nothing of the sort. When a return is received by the tax collector, together with a copy of the filer's W-2(s), that filed return provides the tax collector with evidence of the amount of tax withheld, which the tax collector then credits against the person's tax liability. The actual payment of the taxes withheld, however, depends on the actions of the employer/withholder. *See* 35 **ILCS** 5/1002d (authorizing a personal liability penalty against a responsible officer/employee of an employer that has not paid tax monies withheld from its employees' wages).

Taxpayers' argument, moreover, ignores the pertinent regulation's requirement that a taxpayer either establish that he has filed a return with the foreign state (86 Ill. Admin. Code § 100.2197(g)(1)), or in the alternative, establish that the foreign state did not require him to file a return, and that tax was, in fact, withheld for payment to the foreign state. 86 Ill. Admin. Code § 100.2197(g)(2). Taxpayers have not argued that

Oklahoma law did not require them to file a return. *See* Taxpayers' Brief; Taxpayers' Reply. And since taxpayers failed to offer the critical foundation necessary to establish that the return admitted into evidence had, in fact, been filed with Oklahoma, they have not shown that they are entitled to the credit authorized by IITA § 601(b)(3) for 1999. 35 **ILCS** 5/601(b)(3); 86 Ill. Admin. Code § 100.2197(g)(1).

Issue II: Number of Allowable Personal Exemptions for 2002

The Illinois income tax is measured by a taxpayer's net income (35 **ILCS** 5/201(a)), which is defined as, "that portion of his base income for such year which is allocable to this State under the provisions of Article 3, less the standard exemption allowed by Section 204 and the deduction allowed by Section 207." 35 **ILCS** 5/202. Section 204 describes three types of exemptions, the sum of which constitutes Illinois' standard exemption. 35 **ILCS** 5/204(a). Each separate exemption is currently, and was, during 2002, valued at $2,000. 35 **ILCS** 5/204(b)(3). The first type of exemption allowed by § 204 is the basic amount, which is granted to each individual taxpayer, and to his spouse, if they file a joint return. 35 **ILCS** 5/204(b). The second type is one for each of the taxpayer's dependent children. 35 **ILCS** 5/204(c). That is the exemption at issue here. The third type grants an exemption for the taxpayer, and his spouse if filing jointly, if either or both is over 65 or is blind. 35 **ILCS** 5/204(d).

Section 204 (c) provides:

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> (c) Additional amount for individuals. In the case of an individual taxpayer, there shall be allowed for the purpose of subsection (a), in addition to the basic amount provided by subsection (b), an additional exemption equal to the basic amount for each exemption in excess of one allowable to such individual

> taxpayer for the taxable year under Section 151 of the Internal Revenue Code.
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35 **ILCS** 5/204(c). As the quoted text reflects, the exemption for dependents is equal to the one "allowable to such individual taxpayer for the taxable year under Section 151 of the Internal Revenue Code." 35 **ILCS** 5/204(c).

Section 151 of the Internal Revenue Code (Code) provides, in pertinent part:

> § 151. Allowance of deductions for personal exemptions
> (a) Allowance of deductions
> In the case of an individual, the exemptions provided by this section shall be allowed as deductions in computing taxable income.
> (b) Taxpayer and spouse
> An exemption of the exemption amount for the taxpayer; and an additional exemption of the exemption amount for the spouse of the taxpayer if a joint return is not made by the taxpayer and his spouse, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.
> (c) Additional exemption for dependents
> (1) In general
> An exemption of the exemption amount for each dependent (as defined in section 152) -
> (A) whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than the exemption amount, or
> (B) who is a child of the taxpayer and who (i) has not attained the age of 19 at the close of the calendar year in which the taxable year of the taxpayer begins, or (ii) is a student who has not attained the age of 24 at the close of such calendar year.
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> (d) Exemption amount
> For purposes of this section -
> (1) In general
> Except as otherwise provided in this subsection, the term "exemption amount" means $2,000.
> (2) Exemption amount disallowed in case of certain dependents

In the case of an individual with respect to whom a deduction under this section is allowable to another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins, the exemption amount applicable to such individual for such individual's taxable year shall be zero.

(3) Phaseout

(A) In general

In the case of any taxpayer whose adjusted gross income for the taxable year exceeds the threshold amount, the exemption amount shall be reduced by the applicable percentage.

(B) Applicable percentage

For purposes of subparagraph (A), the term "applicable percentage" means 2 percentage points for each $2,500 (or fraction thereof) by which the taxpayer's adjusted gross income for the taxable year exceeds the threshold amount. In the case of a married individual filing a separate return, the preceding sentence shall be applied by substituting "$1,250" for "$2,500". In no event shall the applicable percentage exceed 100 percent.

(C) Threshold amount

For purposes of this paragraph, the term "threshold amount" means -

(i) $150,000 in the case of a joint return or a surviving spouse (as defined in section 2(a)),

(ii) $125,000 in the case of a head of a household (as defined in section 2(b),(!1)

(iii) $100,000 in the case of an individual who is not married and who is not a surviving spouse or head of a household, and

(iv) $75,000 in the case of a married individual filing a separate return.

For purposes of this paragraph, marital status shall be determined under section 7703.

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(e) Identifying information required

No exemption shall be allowed under this section with respect to any individual unless the TIN of such individual is included on the return claiming the exemption.

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26 U.S.C. § 151.

Here, the Department denied taxpayers' claim for an exemption for each of their two children on their amended 2002 Illinois return, because taxpayers were not allowed the corresponding exemptions by the Internal Revenue Service (IRS) for purposes of their joint federal return for that year. Tr. pp. 17-18 (opening statement); Department's Brief, pp. 3-5. The Department argues that the exemptions were denied at the federal level because taxpayers' AGI was such that their dependent exemptions were phased out under Code § 151(d)(3). Department's Brief, pp. 3-5. Taxpayers counter that, while their dependant exemptions were phased out for purposes of federal law, there is no similar phase out under Illinois law. Taxpayer's Brief, p. 2. Taxpayers also argue that the instructions for Department form IL-1040 do not indicate that there are any limitations or phase out of the exemptions for a taxpayer's dependents, and that they instead state that the number of exemptions entered on Form IL-1040 should equal the number of exemptions claimed on IRS Form 1040, line 6b. *Id*.

The Department concedes that the instructions to the 2002 form IL-1040 state that a taxpayer should "[w]rite on your Form IL-1040, Line 12a, the number of exemptions you claimed on your federal return." 2002 Form IL-1040 Instructions, p. 12 (pdf at http://www.revenue.state.il.us/taxforms/incm2002/ind/il1040-inst.pdf) (last viewed on August 30, 2007); Department's Brief, p. 4. On the other hand, the Department is also correct when it argues that the scope of the standard exemption for a taxpayer's dependents is fixed by § 204(c), not by the general instructions written to guide taxpayers on how to complete the Illinois individual income tax return form. Section 204(c) clearly provides that the exemption for dependents is equal to the one "allowable to such

individual taxpayer for the taxable year under Section 151 of the Internal Revenue Code." 35 **ILCS** 5/204(c).

Taxpayers do not dispute that the exemptions they claimed on their 2002 federal return for their dependent children were disallowed, nor do they dispute that they were disallowed because of Code § 151's phase-out provision. *See* Taxpayers' Brief, p. 3. Since there is no dispute over those facts, the plain text of § 204(c) must be given effect. Taxpayers were not allowed a deduction for their dependents under Code § 151, therefore they are not allowed the corresponding deduction for their dependents under § 204(c). 35 **ILCS** 5/204(c).

Issue III: Abatement of Penalties

The Department assessed three types of penalties against taxpayers, which include: a penalty for underpayment of estimated tax during 1999; a penalty for filing their 1999 return late, and two late payment penalties, one each for 1999 and 2002. Taxpayer Exs. 2, 7 (p. 5), 11. Each such penalty is subject to abatement for reasonable cause. 35 **ILCS** 5/804(e); 35 **ILCS** 735/3-8.

Specifically, § 3-8 of Illinois' Uniform Penalty and Interest Act (UPIA) provides that penalties imposed by §§ 3-3, 3-4, and 3-5 shall not apply if the taxpayer shows that his failure to file a return or pay a tax when due was due to reasonable cause. 35 **ILCS** 735/3-8. It further provides that reasonable cause shall be determined in each situation in accordance with the rules and regulations promulgated by the Department. *Id*. The Department has promulgated a regulation in which it defined reasonable cause and described how it would administer UPIA § 3-8. 86 Ill. Admin. Code § 700.400. The applicable regulation provides that, "… whether a taxpayer acted with reasonable cause

shall be made on a case-by-case basis taking into account all pertinent facts and circumstances. The most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine his proper tax liability and to file and pay his proper liability in a timely fashion." 86 Ill. Admin. Code § 700.400(b); *see also* PPG Industries, Inc. v. Department of Revenue, 328 Ill. App. 3d 16, 22-23, 765 N.E.2d 34, 40 (1st Dist. 2002). The regulation further provides that, "[a] taxpayer will be considered to have made a good faith effort to determine and file and pay his proper tax liability if he exercised ordinary business care and prudence in doing so. A determination of whether a taxpayer exercised ordinary business care and prudence is dependent upon the clarity of the law or its interpretation and the taxpayer's experience, knowledge, and education. ***" 86 Ill. Admin. Code § 700.400(c).

A taxpayer challenging a penalty assessment has the burden to show that, under the circumstances, a penalty should not have been imposed. 86 Ill. Admin. Code § 700.400(b). It satisfies that burden with documentary evidence showing ordinary business care and prudence, and not through mere testimony. PPG Industries, Inc., 328 Ill. App. 3d at 33, 765 N.E.2d at 48. Here, however, not only was there no documentary evidence offered that was relevant to the penalty issue, there was little if any competent testimony offered that was directly relevant to the issue. For example, John Doe testified that he did not prepare either of the original returns filed for 1999 or 2002, but that his wife had. Tr. pp. 30-31 (John Doe). He could not, however, recall when his wife worked on or prepared the returns for those years, and could not recall signing such returns. Tr. pp. 34-35 (John Doe). He offered no testimony about when those returns for 1999 and

2002 were mailed. Considering the dearth of evidence from a witness with personal knowledge of how or when the original returns for 1999 and 2002 were prepared, it is impossible to conclude that John Doe and/or Jane Doe acted in good faith and with ordinary business care and prudence when attempting to timely file their original Illinois return for 1999, and when attempting to timely pay their Illinois income tax liabilities for 1999 and 2002.

The only evidence John Doe offered that indirectly touched upon reasonable cause was his testimonial description of his wife's poor physical health. Tr. pp. 30-32, 36-39 (John Doe). While the incapacity of a taxpayer is one of the factual circumstances that the Department has identified as exemplifying reasonable cause (86 Ill. Admin. Code § 700.400(c)(2)), John Doe's own testimony was that Jane Doe's poor health became manifest only after a traffic accident that occurred in 2005, which was well after the periods at issue. Tr. pp. 30, 32, 39 (John Doe). Even were I to accept John Doe's description of Jane Doe's physical condition in 2005 as being sufficient for me to conclude that she was unable — at that time — to file returns timely and to make timely tax payments, I could not properly draw from such testimony the further conclusion that she was similarly physically unable to exercise ordinary business care three to five years earlier. *See* 86 Ill. Admin. Code § 700.400(f)(3). The evidence showed that Jane Doe was employed at a law school during 1999, one of the years for which penalties were assessed. Taxpayer Ex. 8. Further, John Doe testified that, as of the date of the hearing, Jane Doe was still attempting to pursue her professional activities with the American and Chicago Bar Associations. Tr. p. 36. Thus, I conclude that taxpayers have not supported their claim that any of the penalties assessed should be abated for reasonable cause.

Conclusion:

I recommend that the Director finalize the original denials as revised by the parties' stipulations.

September 25, 2007
Date

John E. White, Administrative Law Judge